



On the Radar Screen

- 1. Falling inflation rates signal the loss of pricing power ahead.** Companies may be experiencing mounting pressure on revenues, profit margins, and earnings. We will be paying close attention to forward earnings guidance more so than past results as we move through this reporting season.
- 2. While goods prices are falling in some cases, wage growth remains robust, keeping services inflation elevated.** The Fed is determined to weaken the labor market to break the wage-price spiral. Watch for a rise in new unemployment claims.
- 3. The repeal of COVID-19 restrictions in China spells near term weakness as a wave of infections sweeps the country but promises solid growth in the aftermath as conditions normalize.**
- 4. Russia is still forming their response to the oil price cap** imposed on Russian crude oil. Should they ultimately elect to ban sales to countries participating in the cap, as is possible, a more acute energy crisis is likely to develop.

Insights from Multi-Asset Solutions' Portfolio Managers

“In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could.”

– Rudiger Dornbusch

Inching toward recession. The drums of recession have been beating a slow roll for some time now, yet we seem little closer to the precipice than was the case six months ago. The labor market remains exceptionally tight in defiance of predictions for trouble ahead. Employers are generally loathe to add headcount if they are concerned about sales prospects, and so the currently strong hiring trends seem inconsistent with an impending contraction. Likewise, companies continue to pursue capacity-boosting and productivity-enhancing plant and equipment investments. CEO sentiment surveys suggest that management is deeply concerned about the year ahead, and yet corporate activity such as the aforementioned indicators of ongoing capital expenditure imply a very healthy operating environment. We're not sure quite what to make of this. Perhaps it is a case of “do as I say, not as I do?” It is similar with consumers, who collectively express little confidence in their financial circumstances but nevertheless continue to spend freely, drawing down their pandemic savings. Supported by both business and household spending, the economy continues to grind along despite the Fed having pulled the emergency brake.

That's unlikely to last. The cost of debt capital has risen dramatically over the past year, putting many household purchases out of reach, inhibiting corporate growth, and jeopardizing the solvency of more marginal business enterprises; the inversion of the yield curve implies—very reliably!—that bond investors foresee a recession on the near horizon; and, consumers and businesses are rapidly running through the fiscal

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support accumulated over the past two and a half years, eliminating these key pillars of support for the economy. Economic activity has thus far defied gravity, but it appears almost inevitable that recession lies ahead. Talk of a “soft landing” strikes us as being something of a fairy tale.

We are reminded of the onset of the Great Financial Crisis and how long that took to gestate. New Century Financial, a mortgage lender specializing in sub-prime and non-conforming jumbo loans, entered bankruptcy in February of 2007. In our assessment of history, that marked the beginning of what was to become a deep and prolonged recession—the longest since the Great Depression.

The next shoe to drop was the collapse of two Bear Stearns hedge funds that summer, but it wasn't until the very end of the year that the U.S. officially entered recession, with Bear Stearns itself failing followed by Lehman Brothers, AIG, Fannie Mae, and a host of others. 2022 has been a bit different. We've seen some catastrophic losses in the more speculative corners of the market—meme stocks, SPACs, crypto, innovative technology, NFTs—but not yet any high-profile failures equivalent to the New Century Financial precedent. That tells us the onset of recession might yet be some distance off. Nevertheless, sledding is likely to remain tough in the leadup to such an event.

One thing we like to say is that nothing is ever certain in this business. We are firm in our belief that a recession looms, driving stocks prices lower as it approaches, but we are keenly aware of the possibility that we will be proven wrong in that assessment. Given that stocks generally rise over time, betting against them has tended to be a losing proposition. As such, we are reluctant to be underweight within our portfolios. We have instead established a neutral posture, but one in which we favor defensive sectors including utilities, staples, and healthcare. Similarly, we are at or near benchmark weight in speculative grade bonds and loans but favor higher quality borrowers and shorter duration instruments within the high yield universe. If and when stocks prices suffer and credit spreads gap wider, as we expect, we believe we will be well prepared to add risk at that time. Until then, we are calling “neutral” asset allocation posture the “new underweight”.

“When goods don't cross borders, armies will.” – Frédéric Bastiat. While we scoff at the notion of a soft landing, we allow for the possibility that fairy tales sometimes do come true. Perhaps the rapid tightening of monetary policy won't be sufficient to push the economy over the edge after all. But that's not the only risk that has our attention. The deepening schism between Western democracies and Eastern autocracies, with the attendant gradual decoupling of our respective economies, also presents a risk. Longer term, it is China's relationship with the West that will have the most profound impact on the trajectory of global growth, but it is Russia's conflict with Ukraine that poses a more immediate hazard. As all have heard, the war has gone badly for Russia. A combination of crippling sanctions and Western support for Ukraine in the form of both materiel and training is pushing Putin into a corner, jeopardizing a non-conventional response; possibly cyber-attacks on Western infrastructure or possibly even the use of tactical nuclear weapons. Any such escalation of the conflict is likely to have a highly detrimental impact on capital markets, if only temporarily. So, we may yet see the swoon in stock prices and widening of credit spreads we expect even absent the recession we believe is coming.

A special purpose acquisition company (SPAC) is a publicly traded company created for the purpose of acquiring or merging with an existing company.

Cryptocurrency is a digital currency using cryptography to secure transactions.

A non-fungible token (NFT) is a unique digital identifier that cannot be copied, substituted, or subdivided, that is recorded in a blockchain, and that is used to certify authenticity and ownership.

There is no assurance that the investment objectives will be met.

Past performance is no guarantee of future results, which will vary. All investments are subject to market risk and will fluctuate in value.

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